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October 29, 1998

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Ms. Magalie Salas, Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

In re Matter of the Pay Telephone Reclassification and
Compensation Provisions of the Telecommunications Act
of 1996, **CC Docket No. 96-128**

Dear Ms. Salas:

On October 29, 1998, Dan Lanksbury and BB Nugent of U S WEST, Craig Stephens of GTE, and Aaron Panner and I met with Larry Strickling, Glenn Reynolds, Richard Cameron and Mark Seifert of the Common Carrier Bureau to discuss issues in this docket. Our presentation consisted of four main points.

First, we explained that payphones are a declining volume business due to competition from PCS and other alternatives. There is fierce competition for a decreasing pool of calling minutes among PSPs, with a dramatic increase in side-by-side competing phones, each relying on different pricing approaches and advertising strategies.

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Second, the one area of the market that is growing is dial-around and 800 calls. The IXCs are heavily advertising such calls and propelling an increasing shift away from 0+ traffic. The IXCs are also purchasing phone card companies, which rely heavily on such calls. All this indicates that the current per-call compensation amount is not a deterrent to such calls and that the IXCs obviously do not find the rate "excessive" in the marketplace, whatever they might tell the Commission for lobbying purposes.

Third, the per-call rate is also not excessive for callers, as witnessed by the increase in access code and 800 calls, notwithstanding the current \$.284 compensation rate. There is no reason why business callers using a credit card should not make as great a contribution to the maintenance of the payphone as local callers using coins. As for 800 subscribers, the choice to use an 800 number is a business one, driven by the revenues or other benefits they stand to garner from the call. There is no reason why they should not also pay fair compensation for the use of the payphone.

Fourth, and most importantly, the increase in dial-around and 800 calls -- coupled with the decrease in other call minutes -- makes the per call compensation rate critical to the survival of PSPs and to the widespread deployment of payphones. U S WEST estimates that approximately 1% of its payphone base would go under water for every penny decrease in the per-call rate. If that holds generally, the nation could lose 24,000 payphones for every penny lost in per-call compensation. Most of those phones, moreover, will be lost in higher cost and generally more rural areas, where payphone service is most needed and where non-local calling accounts for a higher percentage of calls than in urban areas.

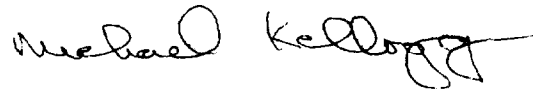
In addition to these points, we also discussed the reasons why consumers would react extremely negatively to any sort of caller pays regime for dial-around and 800 calls, thus further depressing call volumes and accelerating the decline of the industry.

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One original and one copy of this letter and an article that we left behind after the meeting are being submitted to you in compliance with 47 C.F.R. § 1.1206(a)(2) to be included in the record of this proceeding. If you have any questions concerning this matter, please contact me at (202) 326-7902.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Kellogg", with a stylized flourish at the end.

Michael K. Kellogg

cc: Larry Strickling
Glenn Reynolds
Richard Cameron
Mark Seifert

Phone Cards Get Funky

By John N. Frank

As the market continues to grow, more and more players are aiming products at niche segments.

Growth has become a given in the U.S. prepaid phone card market. Sales this year are forecast in the \$2 billion to \$3 billion range, depending on the analyst, up anywhere from 30% to 50% over 1997's level. And such growth is expected to continue into the start of the new century.

But that robust growth masks a fundamental change taking place in the business. The days when virtually any entrepreneur could start a prepaid card business are fading. Major companies, such as MCI Telecommunications Corp., Sprint Corp., WorldCom Inc. and SmarTalk TeleServices Inc., are coming to dominate the retail side of the business. Other major telecommunication providers are buying in or are expected to buy into the market as well, seeking to diversify into more profitable phone-related services. That means more intense competition for shelf space from larger competitors. Smaller firms increasingly are fighting back with niche products aimed at specific market segments. And even the larger players are increasingly introducing niche products to reach markets they might have once ignored or written off as the purview of smaller players.

The number of U.S. prepaid phone card issuers has stabilized around 400, but the profile of that group is changing. Indeed, PT-1 Communications Inc., a relative giant independent operator in the prepaid market with sales of \$431.5 million for the year ended March 31, 1998, recently agreed to be bought by Star Telecommunications Inc., itself a \$404.6-million in annual revenue company that deals in wholesale phone time sales, for 21 million shares of stock (the stock was trading in the \$18-\$21 range shortly after the takeover announcement in June; the value of the deal will be based on the stock's price when the takeover is completed).

Looking at the merger trend in the industry today (see "Phone Card Merger Mania," *Card Technology*, January 1998) Fred Voit, an analyst with the Boston-based Yankee Group, an industry research firm, notes that when he started following the prepaid phone card market in 1994, he would get calls from people wanting information on how they could get into the business. "Now, when I get calls, it's 'how do I sell my (prepaid card) business?'"

The takeover binge is being propelled by the desire to nab established distribution channels for prepaid products, analysts agree. "Success in the marketplace is going to be predicated on who is capable and really being successful at maximizing distribution," says Jeff Lindauer, president of SmarTalk. The days when a consumer had to search long and hard to find a prepaid phone card are over. Today, "the cards are everywhere," says R. David Fehrman, director, imaging service group, with Dayton, Ohio-based Standard Register Co., which makes phone card packaging. Indeed, the PT-1 acquisition was driven by the desire to gain distribution. "It would take a significant amount of time and resources to get where they are, their distribution network was so extensive," says Ben Helvey, director of investor relations with Santa Barbara, Calif.-based Star.

As a result, those staying in the business, whether large or small operators, are increasingly finding they need to target niches to continue their growth. Consumers are becoming more sophisticated about what they need in a card, propelling the specialization trend. Retailers, bombarded with calls from potential phone card suppliers, also are becoming more choosy about the cards they carry. "You're hard-pressed to go to a store or a store buyer and not have him say 'Oh, no, not another phone card,'" says Cory Eisner, vice president of marketing for Philadelphia-based Global Telecommunication Solutions Inc.

GTS has responded to the need to specialize with its GTS Prepaid PhoneCard which offers rates based on distance called. Most phone cards carry flat per-minute rates regardless of where someone is calling. Eisner claims his card is the first to offer variable rates. "Why should you pay the same rate to call Los Angeles as you would to call around the block," he asks. Other unusual features of the GTS card are that it does not expire as do many competitors' cards and it can have value transferred from one card to another, meaning consumers never have to feel they've lost money when they only have a few cents left on an old card, Eisner explains. The new card debuted in April and GTS has had "fabulous response," Eisner says. To survive in the market, which means getting retailers to carry your products, a prepaid card company can "either offer an incredibly great price or a better product," Eisner says. "Other than that, retailers are going to go with the big guys" in the industry

because of brand recognition.

Portland, Ore.-based Carrier Service Inc. doesn't talk much about getting retailer shelf space for its cards. That's because it's targeted a different market, producing prepaid cards that give users airline frequent-flyer miles at the rate of 10 miles for every dollar spent, notes Tom Byrnes, vice president of marketing and sales for Carrier's 1-800-Pre-Paid brand cards. "We are not your traditional prepaid company," notes Byrnes. Rather than simply selling cards, the company positions itself as a marketing and service organization that seeks out companies or organizations with membership ranks to which it can market phone cards. "We've captured a significant share of the business travel market," offering its cards in conjunction with the likes of American Airlines, United Airlines and Reno Air, Byrnes says. The company expects to announce three more airline deals and also is working with Auto Club South in Florida, Tennessee and Georgia to offer a prepaid card to auto club members.

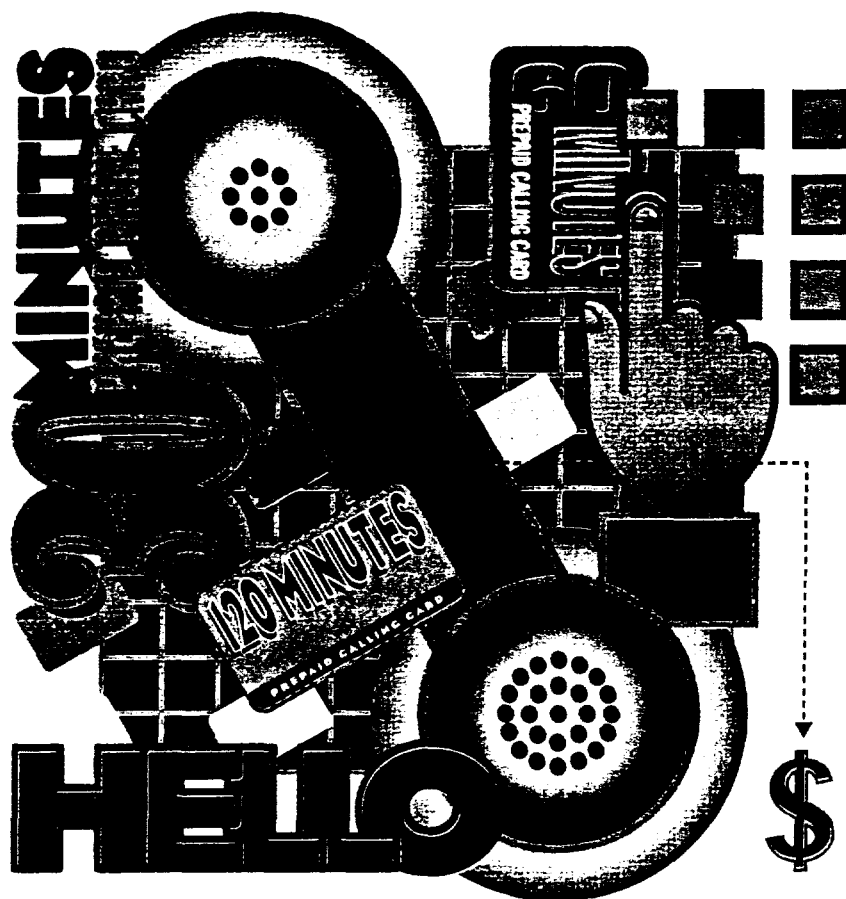
countries as Haiti, Jamaica, Cuba and Colombia. While it serves roughly 4,500 retail locations in Florida, "we find gas stations are by far the best outlets" for the ethnic cards.

New York City-based Digitec 2000 Inc. also markets to ethnic groups, but this summer began offering a new product with a much narrower geographic focus, a card offering a rate of 5 cents a minute for calls in the New York area. That rate is well below industry averages (see story, page 56) and can be offered because the Digitec card uses a local access number rather than an 800 number for consumers to call to use their cards, says Frank Magliato, chief executive officer.

New 800 Change

The federal government has mandated that card sellers have to reimburse pay phone owners roughly 28 cents per call for 800-number calls from their phones. Most phone cards ask users to dial an 800 number to begin their card usage. The charge has boosted operating costs for 800-

While Carrier looks to the skies, other firms continue to look at a traditional major market for prepaid cards—people who regularly call internationally. Miami-based Blackstone Calling Card Inc. distributes roughly 50 different phone cards from a variety of issuers. "We have grown at a rate of 10% a month for the last 14 months" to roughly \$150 million in annual revenues by marketing primarily to ethnic groups, notes Eddie Pena, vice president. Blackstone offers cards for calling such



number cards. Card issuers say they're passing those costs on to consumers in the form of higher rates or calling units deducted to cover the charge. Local access number cards don't need to pay the 800-number charge, however.

On another front, Atlanta-based Quest Group International is targeting college students with its Student PhoneCard. Sold at roughly 150 college bookstores across the United States, it provides students voice mailboxes and access to phone-up information services, explains Richard DeWitt, Quest president. Students can put as much value as they want on a card when purchasing it. Unlike most prepaid phone cards, the Quest student card is not sold for a preset price. DeWitt notes. Add-on services such as voice mail haven't created much of a stir among the general consumer market, but they do appeal to students, DeWitt contends.

Smaller prepaid card companies aren't the only ones offering specialized products. The majors also see the need to offer a variety of cards to the various markets they want to reach. MCI recently announced its MCI Prepaid Shout! card, for example, aimed at parents who want to buy a prepaid card for their children. Parents can program up to six frequently called phone numbers into the Shout! card. Once programmed, calling is limited to those numbers. Children can then dial those numbers by pressing one digit on a phone instead of an entire phone number. Cards come with key ring holders and key rings that can be attached to student backpacks. The new card carries "higher margins than normal utility cards" for MCI, notes Charles Wiggs, executive director of the Alpharetta, Ga.-based MCI Prepaid Group. But given its special features, "consumers won't be looking at rates" when buying the Shout! card, Wiggs predicts.

Another new card area MCI expects to be testing in the third quarter is prepaid cellular phone cards, Wiggs notes. "It's one area all prepaid companies have to have their eye on" given

predictions from Voit and others for future growth.

Indeed, MCI competitor SmarTalk already is marketing a prepaid cellular product nationally, says SmarTalk's Lindauer. Ads with '60s rock legend Dick Clark can be seen on cable television. SmarTalk is selling cellular phones for \$99 with cards carrying \$30, \$50 and \$100 in calling time. In addition to selling direct to consumers, SmarTalk is offering the

product at such retailers as Kmart.

Meanwhile, MCI rival Sprint is going after football enthusiasts with a phone card promotion tied to the National Football League. Buyers of the special \$20 Spree-branded Sprint card hear sports trivia questions from noted sports commentator Chris Berman. Supplying the correct answers to trivia questions, which will change weekly, gives cardholders 20 minutes of free calling time.

A Quick Guide to U.S. Phone Cards

When it comes to card technology, the U.S. prepaid phone card market remains decidedly low-tech. The only chip cards in the U.S. prepaid market are those sold by phone operators U S West Communications and GTE Corp. for the roughly 25,000 smart card-accepting pay phones they've installed. The rest of the market relies on dumb cards, pieces of plastic or paper which normally carry an 800-phone number users dial to make their calls. Card account information is maintained by a central data base, not the cards themselves.

The magnetic stripe, long a fixture on the credit card scene, has found its way onto prepaid phone cards, however, where it is being used to activate the cards at the point of purchase. Retailers concerned about theft had balked at keeping "live" cards, namely those that could be used, on public display. Adding mag stripes and requiring card activation at the time of purchase allayed those fears. Now, inactive cards can be displayed throughout a store. If someone were to steal such cards, they could not be used. Some operators are using bar code activation as well.

Moving phone cards from behind counters and out of locked drawers has been a major boon for sales. Marlene Waltz, director of prepaid cards with Sprint Corp., notes that card sales have been known to rise almost 200% in locations that start displaying cards where consumers can touch the plastic rather than behind lock and key. "Point-of-purchase activation is something you've got to talk about and think about" in today's market, she says.

Point-of-purchase marketing materials and displays also have become a must-have in today's phone card market. Indeed, WorldCom's prepaid card operation found when it did consumer research that the point of purchase was where most consumers decide which phone card they will buy.

The rate offered by various cards also plays a major role in consumer buying decisions, along with convenience, reliability and utility, card sellers agree. Rate pressure on issuers is intense. Distributor Blackstone Calling Card has products priced as low as 5 cents a minute tied to local access numbers and 800-number cards in the 7-cent to 8-cents a minute range, says Eddie Pena, vice president. Most of its 800-number cards are in the 14-cent to 14.5-cent range, he says.

Research firm Frost & Sullivan estimates rates range from 16 cents a minute to 33 cents for regular prepaid cards and 25 cents to 60 cents for prepaid cellular cards. Some major players continue to offer cards carrying rates in the 30-cent range, counting on their brand and quality image to sell the products, notes Howard Segermark, executive director of the International Telecard Association. At least one major issuer, Sprint, is lowering some of its rates, however. Starting Aug. 1, it planned to lower rates on its \$50 card to 24 cents from 29 cents and on its \$100 card from 25 cents to 23 cents. It's also bringing out a \$50 card priced at 25 cents a minute. □

Even those who answer incorrectly are entered in a Super Bowl trip drawing, says Marlene Waltz, Sprint director of prepaid cards. Sprint is shipping the cards to retailers with 6-foot-high point-of-purchase cutouts of vintage NFL players for in-store promotion, Waltz notes.

Promotions Live

Sprint also continues to be active on the promotional side of the prepaid phone card business. While prepaid cards began largely as promotional giveaways, some say that part of the business is not where the action is today. Waltz disputes such poo-pooing of the promotional market. "People who say the promotional prepaid card is dead aren't thinking big enough," she says. Sprint is doing such programs as one it launched with a pharmaceutical company in which the company sent cards to doctors, nurses and patients. Each group was given a different 800 number to call and asked to fill out surveys via the telephone. The company saw a 75% response rate with the cards, Waltz says, compared to less than 10% when it tried a mail-in survey.

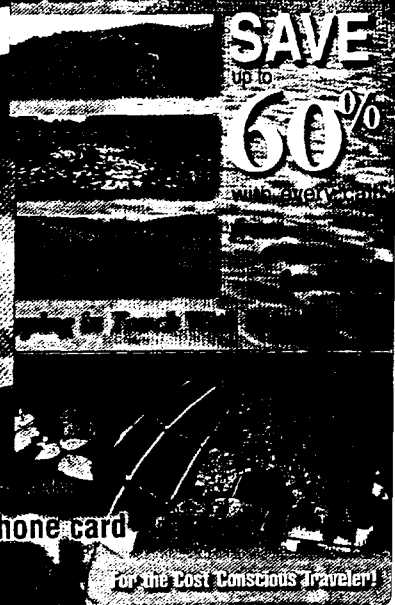
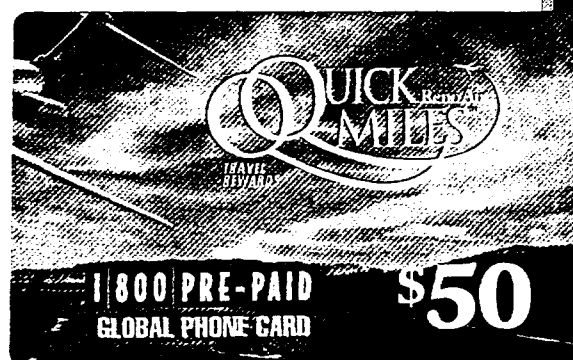
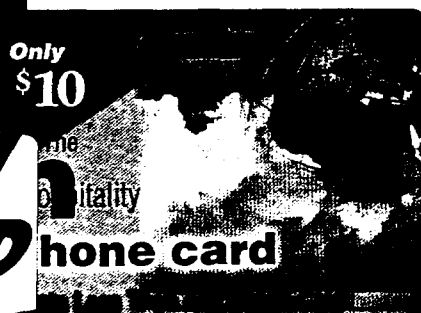
Once Star Telecom completes its PT-1 takeover, something it hoped to do by the end of September, it plans to target card sales in Europe, Australia and the Asian market, says Star's Helvey. Star already has sales offices in London and Germany and will integrate PT-1 card sales into those offices, Helvey says.

WorldCom, meanwhile, is in the process of completing its merger with MCI. When that deal is finished, the phone card operations of the two giants will be merged as well, says Robert Wiggins, president and chief operating officer at WorldCom's prepaid card unit. The two have little customer overlap, he says. As the deal continues to clear regulatory hurdles, WorldCom is targeting a market it hasn't before gone after, recent immigrants looking for cards that will allow them to call their native lands. While phone cards are very popular

among immigrants, that market has "been the preserve of smaller companies," WorldCom's Wiggins notes. WorldCom is marketing the Real (which means Royal in Spanish) Card to Hispanics and also selling the same product under the International Phone Card name at Western Union outlets, he says. While it pursues that new niche, WorldCom will continue to try to increase its mainstream retailer distribution, tailoring offerings to retailer wants. At Sam's stores, for example, WorldCom sells a 120-minute card, basically the large economy size of its product line in keeping

with the warehouse club's emphasis on large-size offerings. Wiggins fairly beams about vendor awards WorldCom cards have received from Target stores and the Albertson's supermarket chain. "Our customer is not just the person who buys the card, but the retailer who buys the card," he says.

WorldCom competitors might envy some of the retailer relationships the phone card giant has, but that isn't stopping them from seeking their own market niches. As the industry grows, look for more and more niche marketing by players trying to prosper in a maturing market. ■



Phone cards range from basic offerings, like Smarttalk and GTS, to cards tied to airline miles or special packaging.